State of California

Board of Equalization
Legal Department-MIC: 83
Office of the Chief Counsel
(916) 445-4380
Fax: (916) 323-3387

Memorandum

To: Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner, Second District
Honorable John Chiang, State Controller

Date: May 10, 2011

From: Randy Ferris
Acting Chief Counsel

Subject: **Board Meeting, May 24-25, 2011**
Chief Counsel Matters - Item J - Rulemaking
Request for Authorization to Make a Rule 100 Change to Sales and Use Tax Regulation 1507, *Technology Transfer Agreements*

On January 18, 2011, the Court of Appeal, Second Appellate District, filed an opinion in *Nortel Networks, Inc. v. State Board of Equalization*[1] concerning the application of Revenue and Taxation Code sections 6011, subdivision (c)(10), and 6012, subdivision (c)(10) (the technology transfer agreement (TTA) statutes) and Sales and Use Tax Regulation (Regulation) 1507, *Technology Transfer Agreements* (the TTA regulation). The opinion was certified for publication and expressly provided that:

> To the extent that regulation 1507, subdivision (a)(1) excludes from the definition of a TTA prewritten computer programs that are subject to a copyright or patent, the regulation exceeds the scope of the Board's authority and does not effectuate the purpose of the TTA statutes: It is, for these reasons, invalid.

On April 27, 2011, the California Supreme Court issued a notice denying the Board's Petition for Review of the Court of Appeal's opinion and left intact the portion of the Court of Appeal's opinion invalidating the last sentence of the definition in Regulation 1507, subdivision (a)(1), which provides that "[a] technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502, *Computers, Programs, and Data Processing.*" As a result of the courts' actions, Board staff requests the Board's authorization to delete the invalid sentence from Regulation 1507, subdivision (a)(1), pursuant to California Code of Regulations, title 1, section (Rule) 100, as illustrated in attachment A. This change to Regulation 1507 can be made under Rule 100 because, pursuant to subdivision (a) of Rule 100, it "does not materially alter any requirement, right, responsibility, condition, prescription or other regulatory element of any California Code of Regulations provision." Further, the change is specifically authorized by Rule 100, subdivision (a)(3),

[1] Court of Appeal, Second Appellate District, case number B213415 and Los Angeles Superior Court case number BC341568.

because the change merely deletes a provision that has been held invalid in a final judgment entered by a California court of competent jurisdiction.

If you need more information or have any questions, please contact Tax Counsel IV Bradley Heller at (916) 323-3091.

Approved:

Kristine Cazadd
Interim Executive Director

RF:bh:yg
J:/Chief Counsel/Finals/Board Memo -Rule 100 Change to Reg. 1507 – 05-10-2011.doc
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Attachment: Recommended Rule 100 Change to Regulation 1507

cc: Ms. Kristine Cazadd MIC: 73
Ms. Christine Bisauta MIC: 82
Mr. Bradley Heller MIC: 82
Mr. Robert Tucker MIC: 82
Ms. Susanne Buehler MIC: 92

bc:

Ms. Regina Evans	MIC: 72
Mr. Louis Barnett	MIC: 77
Mr. Alan LoFaso	MIC: 71
Mr. Sean Wallentine	MIC: 78
Ms. Mary Jo Mandel	MIC: 73

Ms. Marcy Jo Mandel
Deputy State Controller
777 S. Figueroa Street, Suite 4800
Los Angeles, CA 90017

Recommended Rule 100 Change to Regulation 1507

1507. Technology Transfer Agreements

(a) Definitions.

(1) "Technology transfer agreement" means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that assigns or licenses a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.

A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to technology transfer agreement. ~~A technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502, Computers, Programs, and Data Processing.~~

Example No. 1: Company X holds a copyright in certain tangible artwork. Company X transfers (temporarily or otherwise) its artwork to Company Y and, in writing, transfers (temporarily or otherwise) a copyright interest to Company Y authorizing it to reproduce and sell tangible personal property subject to Company X's copyright interest in the artwork. Company X's transfer of artwork and a copyright interest to Company Y constitutes a technology transfer agreement. Company Y's sales of tangible personal property containing reproductions of Company X's artwork do not constitute a technology transfer agreement.

Example No. 2: Company X holds patents for widgets and the process for manufacturing such widgets. Company X, in writing, transfers (temporarily or otherwise) its patent interests to sell widgets and the process used to manufacture such widgets to Company Y. Company X's transfer of its patent interests to Company Y constitutes a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any widgets that it manufactures does not constitute a technology transfer agreement. Company Y's sale or storage, use, or other consumption of any tangible personal property used to manufacture widgets also does not constitute a technology transfer agreement.

Example No. 3: Company X manufactures and leases a patented medical device to Company Y. As part of the lease of the medical device, Company X also transfers to Company Y, in writing, a separate patent interest in a process external to the medical device that involves the

use, application or manipulation of the medical device. Company X charges a monthly rentals payable for the equipment as well as a separate charge for each time the separate patented process external to the medical device is performed by Company Y. Company X's lease of the medical device to Company Y to perform the separately patented process is not a technology transfer agreement and tax applies to the entire rentals payable for the medical equipment. Company X's transfer of its separate patent interest for the right to perform the separate patented process external to the medical device is a technology transfer agreement. Company X's separate charges to Company Y for the right to perform the separate patented process external to the medical device are not subject to tax provided they relate to the right to perform the separate patented process, are not for the lease of the medical device, and represent a reasonable charge for the right to perform the separate patented process external to the medical device. Where the separate charges for the right to perform the separate patented process relate to the patented technology embedded in the internal design, assembly or operation of the medical device, Company X's separate charges for the right to perform the separate patented process are not pursuant to a technology transfer agreement and are instead part of the rentals payable from the lease of the medical device.

(2) "Copyright interest" means the exclusive right held by the author of an original work of authorship fixed in any tangible medium to do and to authorize any of the following: to reproduce a work in copies or phonorecords; to prepare derivative works based upon a work; to distribute copies or phonorecords of a work to the public by sale or other transfer of ownership, or by rental, lease, or lending; to perform a work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and motion pictures and other audiovisual works; to display a copyrighted work publicly, in the case of literary, musical, dramatic, and choreographic works, pantomimes, and pictorial, graphic, or sculptural works, including the individual images of a motion picture or other audiovisual work; and in the case of sound recordings, to perform the work publicly by means of a digital audio transmission. For purposes of this regulation, an "original work of authorship" includes any literary, musical, and dramatic works; pictorial, graphic, and sculptural works; motion pictures and other audiovisual works; sound recordings, including phonograph and tape recordings; and architectural works represented or contained in tangible personal property.

(3) "Patent interest" means the exclusive right held by the owner of a patent issued by the United States Patent and Trademark Office to make, use, offer to sell, or sell a patented process, machine, manufacture, composition of matter, or material. "Process" means one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but does not mean or include the mere use of tangible personal property subject to a patent interest.

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(4) "Assign or license" means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement.

(b) Application of Tax

(1) Tax applies to amounts received for any tangible personal property transferred in a technology transfer agreement. Tax does not apply to amounts received for the assignment or licensing of a patent or copyright interest as part of a technology transfer agreement. The gross receipts or sales price attributable to any tangible personal property transferred as part of a technology transfer agreement shall be:

(A) The separately stated sale price for the tangible personal property, provided the separately stated price represents a reasonable fair market value of the tangible personal property;

(B) Where there is no such separately stated price, the separate price at which the tangible personal property or like (similar) tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party; or,

(C) If there is no such separately stated price and the tangible personal property, or like (similar) tangible personal property, has not been previously sold or leased, or offered for sale or lease to an unrelated third party, 200 percent of the combined cost of materials and labor used to produce the tangible personal property. "Cost of materials" consists of those materials used or otherwise physically incorporated into any tangible personal property transferred as part of a technology transfer agreement. "Cost of labor" includes any charges or value of labor used to create the tangible personal property whether the transferor of the tangible personal property contributes such labor, a third party contributes the labor, or the labor is contributed through some combination thereof. The value of labor provided by the transferor of the tangible personal property shall equal the separately stated, reasonable charge for such labor. Where no separately stated charge for labor is made, the value of labor shall equal the lower of the taxpayer's normal and customary charges for labor made to third persons, or the fair market value of such labor performed.

(2) Tax applies to all amounts received from the sale or storage, use, or other consumption of tangible personal property transferred with a patent or copyright interest, where the transfer is not pursuant to a technology transfer agreement.

(3) Specific Applications. Tax applies to the sale or storage, use, or other consumption of artwork and commercial photography pursuant to a technology transfer agreement as set forth in Regulation 1540, Advertising Agencies, Commercial Artists and Designers.

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 6011 and 6012, Revenue and Taxation Code; Preston v. State Board of Equalization (2001) 25 Cal. 4th 197, 105 Cal. Rptr. 2d 407.